



Can Capital Markets Bridge the Climate Change Financing Gap?

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Editor's note

It's generally accepted that there is an urgent need for large-scale financing to allow developing countries to mitigate and adapt to climate change. However, there is a yawning gap between the current level of climate change finance (approximately \$8 billion per year) and even the conservative estimates by the World Bank for the amount required by developing countries (\$90 billion-\$210 billion; see footnote 1 at the end of this article).



Closing that gap was high on the agenda at a Climate Change Financing roundtable discussion hosted by Standard & Poor's Ratings Services and Parhelion Underwriting Ltd., a U.K.-based specialist insurance vehicle, in London on June 17, 2010. The objectives of this event were to assess investor appetite for climate change financing, identify innovative financial structures that could be applied to fund climate change projects, and examine the risks and barriers that might prevent their implementation. The event was attended by around 30 participants from the public and private sector, including representatives from multilateral agencies, development banks, investment banks, the insurance industry, policy think tanks, and institutional investors.

For the purpose of this report, we define climate change finance as the provision of financial resources and investment, both public and private, in projects and actions partially or wholly intended to support action on mitigating greenhouse gas (GHG) emissions and adapting to climate change.

Roundtable Conclusions

- Participating investors signaled their commitment to take action--providing policymakers put in place a coherent, transparent, and enforced long-term framework of climate and energy policy and regulation that reduces risk and

minimizes uncertainty. Transparent, well governed, and effectively functioning markets are essential. To stimulate institutional investor involvement, the returns on climate investment must be commensurate with the perceived levels of risk involved and also need to be competitive with business-as-usual investments.

- By tapping the global capital markets, a wide range of new funding instruments could be created to accelerate the transition to a low-carbon economy. Financial instruments will likely vary according to the specifics of the project, business, or technology to be financed.

- Bond markets have a crucial role to play in climate change finance. Many pension funds are already comfortable purchasing fixed-income instruments of this type and maintain large, long-term exposures to bonds. Green bonds, which provide an opportunity to invest in climate change solutions through a fixed-income product, are already proving to be a simple way of engaging institutional investors. Such bonds have been trialed by the World Bank to raise funds for projects seeking to mitigate the rise in GHG emissions and help developing countries affected by climate change. The World Bank issued its inaugural green bonds in November 2008, and has since issued an equivalent of more than \$1.5 billion through 22 transactions in 15 currencies.

- Investors attending the event expressed an appetite for bonds across the risk-return spectrum, not just low-yielding 'AAA' rated securities.

- Project finance and securitization structures, where lenders look primarily to the revenues generated by a project as a source of repayment as well as security, are already providing a viable model for financing the development of renewable energy throughout the world. Two such projects make use of special purpose financing vehicles CRC Breeze Finance S.A. and Alte Liebe 1 Ltd., the debt of which is rated by Standard & Poor's, to fund wind farms. As the risk-return profile of a project changes through the various phases of the development cycle (feasibility, financing, construction, and operating), different types of investors will have a role to play, offering significant scope to recycle funds. On the supply side, the EU has set mandatory targets for renewable energy that require investment of over \$1 trillion by 2020, creating a significant investment opportunity. Many of these projects can be implemented without a carbon price in place as other government subsidies such as feed-in tariffs are already in place.

Policymakers Look To Private Capital To Fund The Shift To A Low-Carbon Economy

Signatories to The Copenhagen Accord agreed in December 2009 to commit to a goal of jointly mobilizing \$100 billion a year by 2020 from the developed countries to finance climate change mitigation and adaptation. In a report two years prior (see footnote 3 at end of this article), the United Nations Framework Convention on Climate Change (UNFCCC) recommended that long-term finance for climate change mitigation and adaptation should be an approximate mix of 15% public (bilateral and multilateral) and 85% private resources.

In our view, however, there is a stumbling block to getting institutional investors to allocate substantial amounts of their capital to low-carbon projects and climate change adaptation activities in developing countries. That is, there needs to be an appropriate risk and reward balance.

Policymakers, meanwhile, are searching for ways to redirect a larger proportion of private capital toward the low-carbon economy as the developed world emerges from recession with severely

depleted public finances. They are closely examining a number of financing mechanisms, such as green funds and securitization structures, that have the potential to mobilize private sector investment on a massive scale in both developed and developing countries.

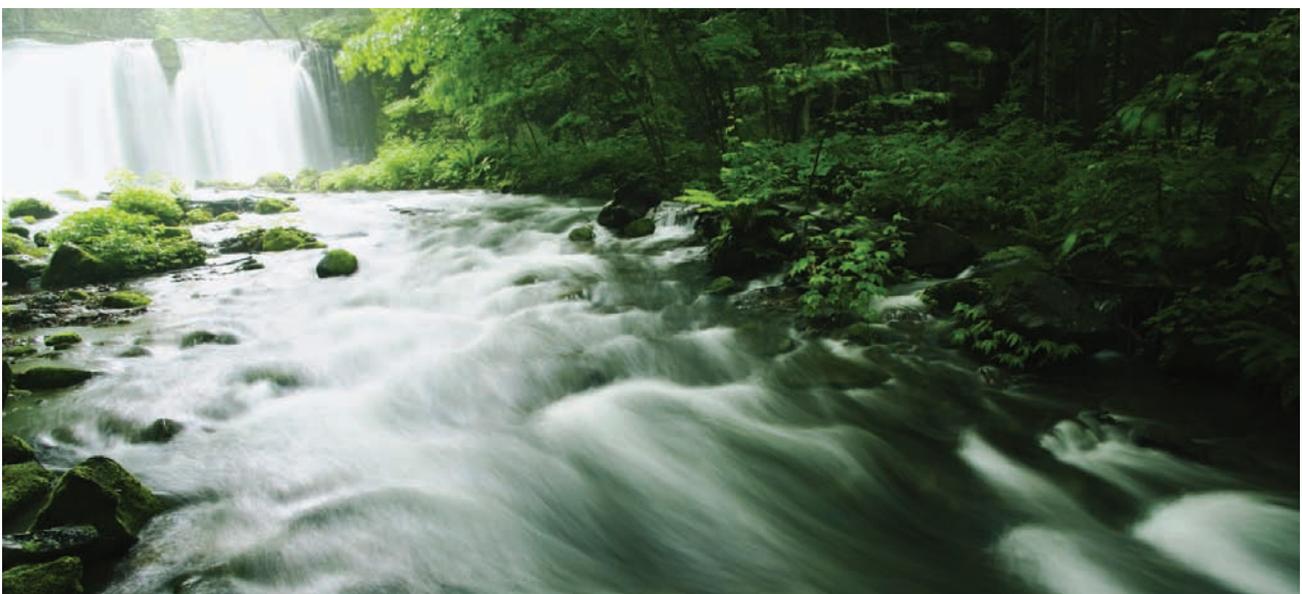
For asset owners and developers, trillions of dollars worth of project finance will need to be raised because new low-carbon companies, renewable energy and infrastructure developments, and projects to improve energy efficiency will need to be financed upfront, in some cases on an industry sector-wide basis. Investors and insurers recognize that businesses are already being affected by climate-related disasters, and will face more of them in the future. With this in mind, we think long-term asset allocations will need to be revised and, over time, high-risk, carbon-intensive companies may need to be divested from portfolios.

Climate Change Investments Are Fraught With Risks

From the roundtable participants' perspective, institutional investors such as pension funds, sovereign wealth funds, and insurance companies have both the ability and the capacity to provide a

significant portion of the finance necessary to transition the global economy to a low-carbon future. However, these asset managers will only invest if they can earn adequate risk-adjusted returns on their capital.

Investing in a low-carbon economy can be extremely risky. As part of the roundtable event, participants examined the risks involved in providing capital for climate change financing structures such as those outlined in the Appendix to this article (see section headed "Innovative Finance Structures Lead The Way To A Low-Carbon Economy"). By listing and categorizing these risks (see table), participants sought to identify the barriers that currently prevent widespread investment by institutional investors in climate change finance. Twelve participants provided additional insight by mapping the risks to their own industry groups of investment and development banking, market infrastructure, policy/academic, and insurance. They addressed the specific risk question *"How to bring innovative financing structures to market: practical issues and challenges in attracting institutional investors. Identification of key risks and concerns for funders and investors in climate change financing."*



Policymakers Look To Private Capital To Fund The Shift To A Low-Carbon Economy - *continued*

The results of this exercise were subsequently analyzed by Parhelion to show how the four main risk categories--policy risks, capacity risks, transaction risks, and project risks--interact in terms of probability and severity (see chart).

The Risks Involved In Securing Climate Change Finance

	Category	Risk	Description
1.	Policy Risks ■	Additionality Risk	Lack of clear environmental additionality
2.		Cannibalisation Risk	Climate budgets are not additive to ODA spending
3.		Enforcement Risk	Rules not fully binding or difficult to enforce
4.		Illegitimate Policy Changes	Nationalisation, confiscation, expropriation, deprivation
5.		Inconsistency Risk	Regional, national, international rules and regulations in conflict
6.		Legitimate Policy Changes	Change in legislation in the ordinary course of government
7.		Longevity Risk	Regulations only in force for a short period compared to investor horizon / capital commitment
8.		Methodology, Reporting & Verification (MRV) Risk	Lack of appropriate methodologies
9.		Multitude Risk	Multiple project types in multiple countries and/or employing multiple technologies
10.	Capacity Risks ◆	Aggregation/ Commoditisation Risk	Difficulty in aggregating &/or commoditising individual transactions into large-scale investment vehicles
11.		Human / Operational	Lack of well trained work force to implement projects
12.		Infrastructure	Poor physical infrastructure
13.		Institutional - property rights	Lack of property rights and/or legal system
14.		Institutional - Regulatory	Lack of well established and resourced regulator
15.		Policy Development Risk	Lack of understanding within policy development role / civil service
16.	Transactional Risks ●	Branding Risk	Public unacceptability of mechanism e.g. market-based solution, securitisation etc.
17.		Complexity Risk	Financial instruments are too complex
18.		Currency Risk	Currency fluctuations
19.		Economic/Commodity Price Volatility	Fluctuation in economic conditions and commodity prices
20.		Fungibility Risks	Lack of fungibility between regimes / environmental instruments
21.		Liquidity Risk	Fragmented measures lead to too many different regimes
22.		Private Sector Funding Shortage	General shortage of funding
23.		Risk/Reward Imbalance	Insufficient returns available given risks involved

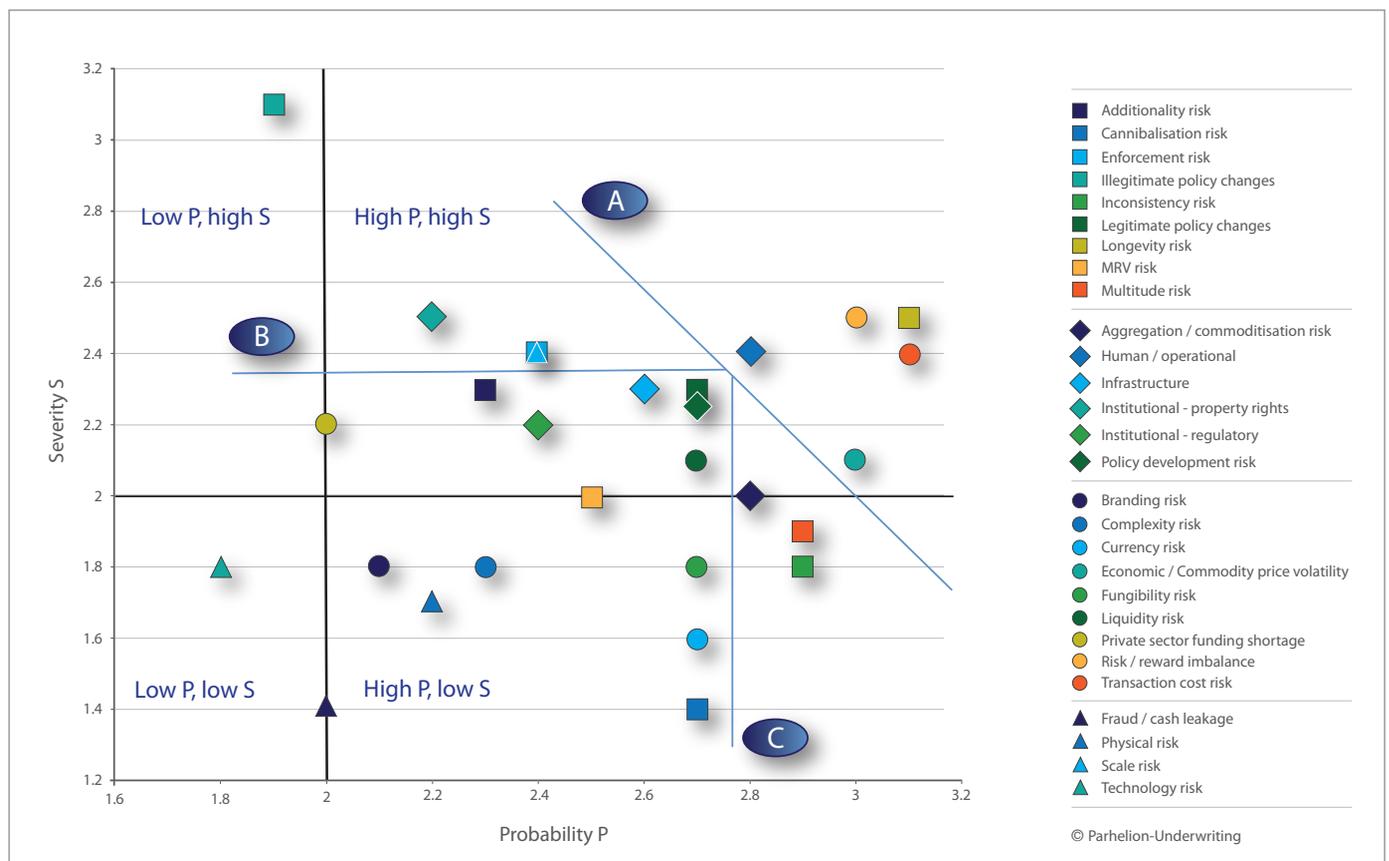
Policymakers Look To Private Capital To Fund The Shift To A Low-Carbon Economy - *continued*

The Risks Involved In Securing Climate Change Finance - *continued*

	Category	Risk	Description
24.		Transaction Cost Risk	High transaction costs, including high costs of complying with MRV requirements
25.	Project Risks ▲	Fraud/Cash Leakage	Investment eroded by leakage costs &/or fraud
26.		Physical Risk	Natural hazards, including fire, explosion, war, machinery breakdown and other material damage
27.		Scale Risk	Individual project size unattractive
28.		Technology Risk	Technology is not efficient and/or too complex and/or not publically accepted

Source: Parhelion Underwriting Ltd

Risk List - Average Probability and Severity Scales



■ Policy risks ◆ Capacity risks ● Transaction risks ▲ Project risks

Source: Parhelion Underwriting Ltd.

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Longevity Risk Appears The Most Likely-- And Most Severe--Test For Funding

According to Parhelion's analysis, while all risks should be carefully considered and managed when considering a climate change financing investment, it is appropriate for policymakers to initially focus their attention on those risks with the highest probability and severity (the area of the chart marked "A"). The risks involved here are:

- Longevity Risk,
- Risk/Reward Imbalance,
- Transaction Cost Risk,
- Human and Operational Risk,
- Economic/Commodity Price Volatility

(see table on previous page for specific risk definitions).

That Longevity Risk is perceived by our roundtable participants to have the highest probability and severity provides confirmation, in our view, that investors are most concerned with the apparent mismatch between the long-term nature of capital commitments inherent in climate change financing and the relatively short time frame of climate change regulations. Investment horizons and/or capital commitment periods can range from 20 years for a reasonably sized renewable energy project to 50 years or more for a climate change adaptation-related investment. Compare this with the duration of regulations that promote climate change investments: In the U.K., for example, Renewable Obligation Certificates provide an additional source of revenue for renewable energy producers. The amount of revenue available is partly driven by the level of renewable energy targets set by government. Yet, while targets have been espoused by government to 2037, they have only been legislated for until 2027. Even these legislated targets are still subject to change and investors are typically reluctant to rely on them fully.



We believe the relatively high probability and severity attached to the Risk/Reward Imbalance shows that financiers are concerned that insufficient returns will be generated given the risks involved in a project. This illustrates a key point that it's not sufficient to create a return for investors; the return must be attractive relative to all other investment opportunities. Therefore, to stimulate institutional investors' involvement in climate change finance, the returns expected on climate investments must be commensurate with perceived levels of risk and also competitive with the returns on normal business investments. As a consequence, we think risk transfer instruments, and especially insurance, have an important role to play. The harsh reality facing both policymakers and climate campaigners is that soft capital is in limited supply--investors require an appropriate return, even in climate change investments.

The relative levels of probability and severity for Transaction Cost Risk (high) against Complexity Risk (relatively low) provide an interesting comparison, in our view. We conclude that investors and funders are able to deal with the complexity of a climate change financing project--provided it does not add significant costs to a transaction, thereby reducing the project's risk-return

characteristics. This is borne out of investors' experience in developing projects under the Kyoto Clean Development Mechanism (CDM), where they quickly dealt with the complexity of a CDM project but struggled with its transaction costs.

Economic/Commodity Price Volatility Risk also ranked among the top five risks for high probability and severity. In the roundtable panels' view, this reflects that other basic and pressing needs may detract from climate change finance flows in periods of low or negative economic growth.

If our roundtable participants are indicative of the industry groups they represent, funders and investors in climate change financing are also concerned that a lack of a well-trained workforce to implement projects (that is, Human/Operational risk) will significantly affect the willingness to invest. The roundtable consensus was that policymakers should develop an integrated policy that not only creates a high-level framework for climate change finance, but also a supporting operational infrastructure. Equally this provides a demand signal to industry to develop the necessary skills and competencies necessary for the implementation and delivery of climate finance.

Unexpected Policy Changes Pose The Greatest Threat To Investments

The most severe risks highlighted by the roundtable participants (the chart area marked “B”) were:

- Illegitimate Policy Changes;
- Institutional and Property Rights;
- Enforcement Risk; and
- Scale Risk.

Illegitimate policy and regulatory changes such as currency transfer restrictions, expropriation, war and civil disturbance, breach of contract, and sovereigns not honoring financial obligations pose a real threat to climate change financing. Such changes in policy are deemed catastrophic to giving incentives for low-carbon investments. However, the relatively low probability given by roundtable participants to the likelihood of this risk occurring reflects that investors can simply avoid those countries where there is a history of illegitimate policy changes. Therefore, if a country is not considered a safe place to invest for normal commercial activities, it is also unlikely to attract climate change finance. This may be reflected by experience with the CDM: Africa, for example, well-known for political risks, has struggled to attract interest. One possible way forward would be to offer affordable political risk insurance, which can protect investors against illegitimate policy changes.

According to our roundtable participants, the risk of Legitimate Policy Changes also is probable and significant. These changes refer to the risk that policies may be amended in the ordinary course of government and from government to government in the same country as political and economic circumstances change. That both Illegitimate and Legitimate policy changes are high on the risk agenda of investors and funders suggests that they will more likely get involved in climate change financing if governments and regulators create a regime beyond the normal reach of political interference.

Moreover, the regime should contain clear and predictable long-term targets, measures, and enforcement mechanisms. Roundtable participants also opined that solutions should be found to accommodate investors and funders in their search for protection against legitimate policy changes--along with the blurry boundary with illegitimate policy changes. The need to create what Chatham House, a U.K.-based nongovernmental organization, calls Investment Grade Policy (which includes a comprehensive policy and legal framework that reduces the financing barriers, intensifies capacity building and knowledge transfer, and implements clarity and predictability) also becomes apparent--and a huge challenge.

Linked to the political risk, investors among our roundtable participants fear a lack of property rights and/or the legal system in the host country where a particular low-carbon economy investment is made (that is, institutional and Property Rights Risk). This risk recognizes that climate change finance will be largely flowing from the developed world to the developing world, where institutions and property rights are often weaker. So countries seeking to attract climate change finance may need to strengthen their governance and accountability. This issue is also linked to Enforcement Risk, where investments in a developing country are liable to expropriation because the legal system is less robust and rights are less well established than in the developed world. Roundtable participants perceive Enforcement Risk to be severe for climate change investments.



Multiple Projects And Complexity Add To The Uncertainties

The most probable risk scenarios identified by our roundtable panel (found in the area of the chart marked "C") were:

- Multitude Risk (that is, multiple projects in a number of countries and/or employing multiple technologies);
- Inconsistency Risk; and
- Aggregation/Commoditization Risk (that is, difficulty in aggregating and/or commoditizing individual transactions into large-scale investment vehicles).

Multitude Risk and Aggregation/Commoditization Risk are both seen as relatively high on the probability scale, according to our roundtable participants. In terms of severity, however, these risks are perceived as relatively less significant, although not insignificant. This may reflect the range of projects seeking climate change finance and the differing needs of countries exposed to the implications

of climate change. We note the similar ranking of these risks, since Multitude Risk may lead to, or be a cause of, Aggregation/Commoditization Risk. Moreover, these risks are also related to Scale Risk (that is, where individual project size is unattractive to investors), which is perceived by the roundtable panel to be low in terms of probability but significantly severe when it occurs. In our view, this may indicate that funders and investors think that there is a multitude of small-scale climate change finance projects; if a small-scale individual project cannot be aggregated into a large-scale investment, it may not be attractive to investors. Roundtable participants were of the opinion that such risks could be minimized by harmonizing policy and regulation across borders wherever possible.

In addition, roundtable participants were of the view that regional, national, and international rules and regulations will likely be (or are) in conflict (in other words, inconsistency risk). They believe policymakers should be encouraged to adopt a multi-dimensional approach, taking into account the geospatial, operational, and institutional dimensions of climate change finance when regulating at different policy levels.



Risk Ranking Allows Policymakers A Clearer View Of The Way Forward

Since international policymakers view the mobilization of substantial amounts of private sector capital into climate change financing within the next two years as a major priority, we see the results of this risk-ranking exercise as a useful illustration of the obstacles that

need to be cleared in order to achieve this aim. Our roundtable participants, by identifying and prioritizing the risks that are generally viewed as the key stumbling blocks to attracting institutional investment, have provided critical insight for policymakers under current economic

conditions. Should global economic and environmental conditions change, the risk ranking may differ in order of priority and perhaps even in severity. However, we believe the types of risks identified are unlikely to change substantially.

Footnotes

1. World Bank (2009), Development and Climate Change. World Development Report 2010.
2. Parhelion Underwriting Ltd. is a U.K.-based specialty insurance and risk transfer business focused on climate change, carbon finance, and renewable energy markets. For more information, visit the company's Web site at www.parhelion.co.uk.
3. Investment and Financial Flows to Address Climate Change, UNFCCC, 2007.

The authors would like to acknowledge the contribution of Matthew McAdam to this article.

Appendix: Innovative Finance Structures Offer Support For Climate Change Investments

In the opinion of participants at the roundtable event, many of the proposals and structures related to climate change financing that were discussed could be viewed as complimentary to the three flexible mechanisms of the Kyoto Protocol, which is due to expire at the end of 2012. Furthermore, such proposals and structures could be applied in both developed and developing countries.

All three Kyoto Protocol mechanisms--the CDM, Joint Implementation (that is, projects in developing countries generating emission reductions that can be sold to developed countries), and international emissions trading--have played a crucial role in engaging the finance and investment communities in thinking about climate change. However, according to our roundtable participants, the level of private sector investment needed requires the urgent mobilization of additional sources of capital on a considerably bigger scale.

The bond markets represent one possible source with the depth and scale of investment required, in our view. Investors are already familiar with bond instruments; as of 2009, the size of the worldwide bond market (total debt outstanding) was an estimated \$82.2 trillion (source: Bank for International Settlements data as of March 31, 2009).

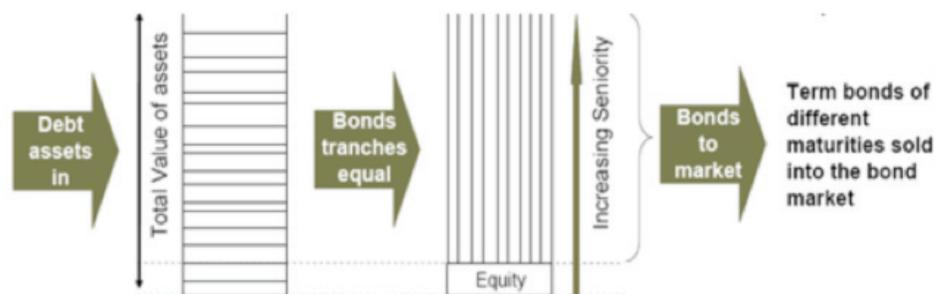
Within the bond markets, innovative structures, ranging from project-based asset-backed securitization to carbon-linked structured sovereign debt (see boxes 1 and 2), are put forward by investors and financial institutions as potential solutions to meet the demand for climate change investments. The public sector similarly offers sources of additional finance for climate change projects, including carbon taxes, receipts from carbon allowance auctions, and a dedicated Green Fund (see boxes 3 and 4).

Box 1 Aggregation Structures Pool Finance For Small-Scale Projects

With high upfront development and construction costs and lower ongoing variable costs, and predictable long-term income streams, renewable energy assets such as large-scale wind farms and solar plants are perfectly suited to traditional debt financing, argues Jason Langley, corporate finance manager at AXA Investment Managers (AXA). As he points out, the long-term debt profile of renewable energy plant, in some cases up to 15 years and beyond, also matches the long-term liabilities of institutional investors.

Langley notes that banks are adept at providing higher risk renewable energy development finance, but less willing and able than bond markets and institutional investors to provide longer term debt. He feels the transfer of loans from bank balance sheets to institutional investors' balance sheets through securitization structures would allow banks to recycle their capital into building new renewable energy projects, thus enabling a scaling up of financing. Aggregation of loans was also necessary, in his opinion, since debt from an individual renewable project was often too small in scale to form large, liquid bonds suitable for institutional investors. Langley cites The Housing Finance Corporation, which creates a secondary market for debt to increase the supply of funds available for new lending, as an example of how this could be achieved.

The diagram below shows an example of a simple aggregation structure that can be replicated for a renewable energy debt.



Aggregation will allow large bond issuances that are listed on global benchmarks and are therefore liquid enough for Fixed Income Investors

Source: AXA Investment Managers.

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Appendix: Innovative Finance Structures Offer Support For Climate Change Investments - *continued*

Box 2 Green Bond Brings Risk-Sharing To The Fore

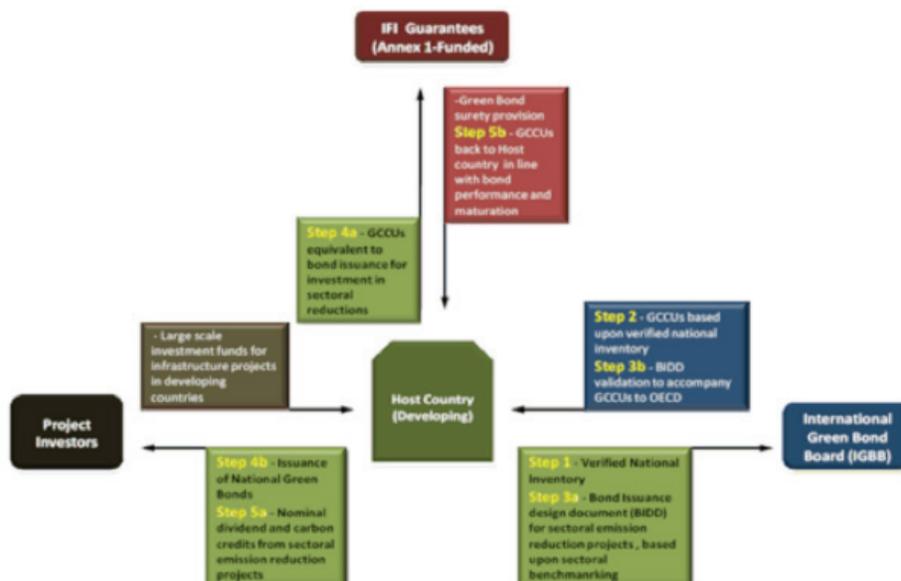
Imtiaz Ahmad, executive director at Morgan Stanley, outlined to roundtable participants the concept of the Green Nationally Appropriate Mitigation Action (NAMA) Bond developed by The International Emissions Trading Association (IETA). Similar to the AXA proposal, the Green NAMA Bond would tap the international debt capital markets, but it also aims to reduce policy and political risks by deploying public guarantees and a risk-sharing structure. According to Ahmad, this would provide improved regulatory stability for investors on a longer term basis. Green NAMA bonds would enable a mechanism of combining returns from sovereign or quasi-sovereign borrowers, conditional guarantees from international financial institutions (IFIs), and underlying project returns expressed in conventional financial terms. The bonds could also take into account carbon units that can be used for compliance by companies or governments with obligations under carbon trading systems, or fulfil voluntary emission-reduction commitments.

The limitation on the facility available to borrower governments would be expressed in Guaranteed Carbon Collateral Units (GCCUs), added Ahmad. The global total of GCCUs would be linked to the total global emissions-reduction ambition of developed countries. The GCCU arrangements would provide an important incentive to focus the borrower's attention on the need to deliver whatever is necessary to achieve emissions reductions—often policy changes or domestic government support to incentivize low-carbon behavior. The GCCUs could be tradable between governments or other licensed borrowers, though they could only be used for projects acceptable to the issuing IFI.

In practice, said Ahmad, Green NAMA bonds would be issued with a low-coupon rate and a stream of carbon credits, the volume of which is tied to the host country's reduction target performance in the given industry sector or subsector. The bond issue would be fundamentally linked to predetermined baselines, standards, and methodologies, as set forth in a bond issuance design document and approved by the proposed international bond oversight and administrative body.

The defined performance target acts as the cornerstone of this hybrid bond concept, says Ahmad, because a green NAMA bond would pay its holders a low coupon from the outset plus a preagreed volume of carbon credits, contingent on the NAMA reductions being achieved. If reduction targets are not met, the bond issuer (that is, the host country) would be obligated to pay a determined cash equivalent to bondholders, thereby increasing the coupon. In which case, the ultimate guarantor(s) for the host country's payment would be one or more IFI(s), providing the guarantee on behalf of (or via) a pool of guarantees from a subset of Organization for Economic Cooperation and Development (OECD) governments.

Ahmad believes the Green Bond concept (see diagram) has the potential to raise substantial private investment at the necessary scale for climate change mitigation activities that are simply uneconomic without an economic price on carbon and a reason to invest.



Source: Morgan Stanley.

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Appendix: Innovative Finance Structures Offer Support For Climate Change Investments - *continued*

Box 3

The European Commission Looks To An International Carbon Market To Deliver Climate Change Funding

Martin Hallet, deputy head of the Globalization, Trade, and Development unit at the European Commission (EC), introduced the roundtable panel to an EC staff position paper titled "Financing the Response to Climate Change," released on March 25, 2010. This paper notes that some instruments, such as a price on carbon and the introduction of emissions trading schemes, offer a significant "double dividend" in both raising revenues for governments and improving market efficiency and stability.

Relative to regulation, said Hallet, the EC concludes that a price on carbon emissions is more efficient as it allows individuals to decide whether they want to continue to pay a price to emit, or whether they prefer to abate their emissions. In this way, carbon pricing identifies the least-cost opportunities of emission abatement and ensures that emission reductions are distributed efficiently across the market, providing a continuous incentive for the firms to invest in energy efficiency and low-carbon technologies.

Carbon taxes, the auctioning of emissions allowances and permits on shipping and aviation were all identified by the EC as potential sources of revenues. Overall, said Hallet, the EU's goal is to develop an OECD-wide carbon market by 2015 and an even broader market, extended to economically more advanced developing countries, by 2020. The EU Emissions Trading Scheme (EU ETS) currently forms the main part of the international carbon market. Transactions of EU ETS allowances accounted for approximately 83% of the total value of the market in 2009. According to Hallet, the EC paper states that a broader international carbon market, if designed properly, would create an increasing financial flow to developing countries and could deliver up to €38 billion per year by 2020 under an ambitious international agreement. An international carbon market could be built by linking compatible domestic cap-and-trade systems.

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Box 4

IMF Puts Forward The Case For A Green Fund

In January 2010, International Monetary Fund (IMF) managing director Dominique Strauss-Kahn proposed the creation of a Green Fund to help finance the shift to a low-carbon economy and to act as a bridging mechanism to large-scale carbon-based financing in the medium term. The fund would have the capacity to raise resources on a scale commensurate with the Copenhagen Accord of \$100 billion a year by 2020.

According to Hugh Bredenkamp, IMF deputy director, Policy, Strategy and Review Department, the IMF has started discussions with central banks and finance ministers on the feasibility of such a fund, possibly partly financed through the issuance of additional special drawing rights (SDRs). Previously, investor George Soros has proposed that rich countries hand \$100 billion of their SDRs for 25 years to a special green fund to be used for loans to developing countries for immediate use to combat climate change. This proposal is of particular relevance in the context of implementing The Copenhagen Accord and its commitment to mobilize long-term finance from a wide variety of sources.

As soon as SDRs are converted into hard currency for the finance to be released, says Bredenkamp, they would incur interest payable by the SDR donor countries to the IMF, which currently stands at a rate of below 0.5%. If donor countries were unwilling to pay this interest, it could be reimbursed by the fund (as a return on the equity in the fund held by donor countries, for example) on the basis of the interest payments that the fund receives from developing countries drawing on the financing. Under the Soros proposal, the developing countries' payments of interest and principal would be guaranteed by the IMF's gold reserve. Developing countries could make money from their low-carbon investments from the SDR fund by selling carbon credits from projects under the U.N.'s Clean Development Mechanism.

As Bredenkamp points out, an important consideration in the context of financing through SDRs is that, as soon as SDRs are activated in order to be used outside of central banks' balance sheets, it is akin to money creation, which is inflationary. One way of circumventing this problem is to refrain from using the SDRs directly (and hence to leave them deactivated), but treat them as a guarantee for debt securities issued by the fund in the capital markets. An additional benefit is that leverage would help to increase the overall amount of funding available.

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